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No. 90-1825

In the Supreme Court of the United States

OCTOBER TERM, 1991

NORTHWEST RACQUET SWIM & HEALTH CLUBS, INC.,
PETITIONER

v.

RESOLUTION TRUST CORPORATION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

KENNETH W. STARR
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

ALFRED J.T. BYRNE
General Counsel

GERALD L. JACOBS
Special Counsel

ANN S. DUROSS
Acting Assistant General Counsel

RICHARD J. OSTERMAN, JR.
Senior Counsel

GREGORY E. GORE
Counsel
Resolution Trust Corporation
Washington, D.C. 20429

QUESTION PRESENTED

Whether petitioner is entitled to rescind its purchase of subordinated securities from a now insolvent thrift institution where the purchase agreement and the applicable regulations indicated that the securities would be used to meet the institution's regulatory capital requirements.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A3-A19) is reported at 927 F.2d 355. The September 25, 1989, memorandum opinion and order of the district court (Pet. App. A20-A33) is reported at 721 F. Supp. 211. The December 5, 1989, memorandum opinion of the district court (Pet. App. A35-A39) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on February 28, 1991. The petition for writ of certiorari was filed on May 28, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Federal Home Loan Bank Board formerly served as the principal regulator of federally chartered thrift institutions.[1] Among other matters, the Bank Board specified terms and conditions under which thrift institutions could issue subordinated debt securities. See 12 C.F.R. 563.8-1 (1988). On December 21, 1987, the Bank Board approved a request from Midwest Federal Savings and Loan Association (MWF), a federally insured savings institution, to issue up to $25 million in MWF subordinated debt securities. Petitioner, Northwest Racquet Swim & Health Clubs, Inc., purchased $15 million of those securities from MWF through a private offering. Petitioner financed its investment with the proceeds from two promissory notes with MWF, totaling $59 million, that it executed shortly before the securities purchase. Shortly after the consummation of the sale, MWF applied the securities to its regulatory capital. Pet. App. A4-A6, A21-A23.[2]

Petitioner and MWF entered into a "Subordinated Debt Securities Agreement" at the time of the pur-

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[1] The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, abolished the Bank Board and replaced it with the Office of Thrift Supervision, §§ 301, 401, 103 Stat. 278, 354; see 12 U.S.C. 1462a (Supp. I 1989).

[2] Federally chartered financial institutions must meet federally prescribed capital requirements. Under the Bank Board's regulations, regulatory capital included reserve accounts, retained earnings, permanent common stock, securities constituting equity capital, appraised equity capital, and any other nonwithdrawable reserve accounts that could be used to satisfy the claims of depositors and other account holders. Pet. App. A6 n.8. The Bank Board also included subordinated debt securities as regulatory capital pursuant to 12 C.F.R. 561.13(c)(1) (1988). See Pet. App. A6 n.8.

chase. The Agreement gave petitioner certain limited remedies in the event of MWF's default.[3] First, it provided that petitioner could accelerate payment in the event of default only to the extent that such payment did not leave MWF with insufficient capital to meet regulatory capital requirements set out in 12 C.F.R. 563.13 (1988). Second, it stated that if the Federal Savings and Loan Insurance Corporation (FSLIC) were appointed as a receiver for MWF, FSLIC would not have any obligation to arrange for the assumption of the securities.[4] Third, it provided that petitioner agreed to abide by the Bank Board's priority regulations governing the distribution of assets in receivership proceedings. Both the security instruments themselves and the Agreement expressly provided that, in the event MWF were liquidated, petitioner's interests would be subordinated to claims of savings account holders and to all other claims having a priority equal to or greater than that of savings account holders. Pet. App. A4-A6, A21-A22.

2. In January 1989, the Bank Board concluded that MWF had improperly treated the securities issued to petitioner as regulatory capital, because petitioner had purchased them with unsecured funds borrowed

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[3] The Agreement defined default by MWF to include the failure to make timely payments of interest or principal, the declaration of insolvency and appointment of a conservator, receiver or liquidating agent, and any false representations or warranties made by MWF in connection with the contemplated transactions. Pet. App. A5.

[4] Congress has since abolished FSLIC. See FIRREA, § 401(a), 103 Stat. 354. The Resolution Trust Corporation (RTC) assumed the FSLIC liquidation function for all savings and loan institutions placed in conservatorship or receivership after January 1, 1989. FIRREA, § 501(b)(3)(A), 103 Stat. 369, 12 U.S.C. 1441a(b)(3)(A) (Supp. I 1989).

from MWF. The Bank Board ordered MWF prospectively to cease treating the securities as such. Shortly thereafter, petitioner notified MWF that it considered the subordinated debt securities to be in default, accelerated payment of the principal, and demanded immediate payment. It also declared a set-off of MWF's obligations to petitioner under the securities arrangement against the amounts petitioner owed MWF under the two promissory notes that petitioner had used to finance the securities purchase. Pet. App. A6-A7, A23.

On February 13, 1989, the Bank Board declared MWF insolvent and appointed the FSLIC as conservator for the institution. One month later, petitioner returned the securities with a letter of rescission declaring that MWF had misrepresented its financial condition and that petitioner was entitled to an immediate set-off. Shortly thereafter, petitioner filed a complaint in state court alleging that MWF's misrepresentations at the time of the sale violated both federal and state securities laws. Petitioner asked the court to declare that the securities sale was rescinded and that the rescission gave petitioner the status of a general creditor, thus entitling petitioner to set-off the amount MWF owed it for the securities against the amount petitioner owed MWF on the notes. Pet. App. A7-A8, A23-A24.

On May 4, 1989, the Bank Board determined that MWF remained insolvent, and it appointed FSLIC as receiver pursuant to 12 U.S.C. 1464(d)(6)(A) and 12 C.F.R. Pt. 547 (1988) for the purpose of liquidating the institution. The Bank Board also found that the total liquidation of MWF could not generate sufficient funds to satisfy the claims of MWF's general creditors, and it therefore determined that all equity and

subordinated debt interests in MWF were worthless.[5] To effectuate the liquidation, the Bank Board created a new institution, Midwest Savings Association (Midwest), and immediately placed it into conservatorship. The Bank Board then directed FSLIC to enter into a purchase and assumption agreement with Midwest by which the majority of MWF's assets were transferred to Midwest in consideration for Midwest assuming certain liabilities of the failed institution. Under the agreement, Midwest did not assume any MWF subordinated debt or equity liabilities or obligations. As a result, Midwest received petitioner's promissory notes while FSLIC, as receiver for MWF, retained MWF's obligations on the securities. Pet. App. A8-A9, A24.

3. Petitioner's pending civil action was removed to the United States District Court for the District of Minnesota. Pet. App. A24 n.3. FSLIC, acting as conservator for Midwest and receiver for MWF, then sought to dismiss petitioner's claims seeking rescission of the securities transaction and a set-off against the promissory notes. On September 25, 1989, the district court granted FSLIC's motion, on behalf of Midwest, for summary judgment. *Id.* at A20-A33. The district court concluded that petitioner was estopped from rescinding its purchase because petitioner presumptively knew that the securities were used to increase MWF's regulatory capital, and the court concluded that petitioner was not entitled to a set-off because the securities and the promissory notes were not mutual obligations. *Id.* at A26, A29. The Resolu-

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[5] Under the FSLIC priority scheme, subordinated debt holders were paid only after all other creditors, except equity interest holders, were paid. 12 C.F.R. 569c.11 (1989). See Pet. App. A6 n.7.

tion Trust Corporation (RTC) thereafter assumed FSLIC's conservatorship and receivership responsibilities. On December 5, 1989, the district court granted the RTC's motion, on behalf of MWF, for summary judgment. The court rejected petitioner's claims against MWF for the same reasons that it rejected petitioner's claims against Midwest. *Id.* at A34-A39.

4. The court of appeals affirmed the district court's decisions. Pet. App. A3-A19. The court of appeals agreed with the district court that petitioner "clearly subordinated its investment in a manner that made it eligible for use as regulatory capital," *id.* at A17, and that petitioner's investment "must be regarded as fully encumbered by the regulatory obligation to remain subordinate to the claims of depositors and general creditors in the event of insolvency," *id.* at A18. Thus, once MWF was declared insolvent, petitioner could not rescind the obligation. *Ibid.* "The continuing subordinated status of the Securities means that they lack the requisite mutuality of obligation required to set them off with the promissory note which possesses a superior general creditor rank." *Id.* at A18-A19.

ARGUMENT

The court of appeals correctly affirmed the district court's determination that petitioner was not entitled to a rescission or set-off of the subordinated debt obligation. The court's decision rests on the application of established law to the facts of this case and does not conflict with any decision of this Court or another court of appeals. Further review is accordingly unwarranted.[6]

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[6] The same issue is presented in the petition for a writ of certiorari in *Adams* v. *RTC*, No. 90-1851.

1. The court of appeals and the district court held that where a federally regulated financial institution has issued a subordinated debt security to meet regulatory capital requirements, an investor cannot rescind his purchase of the security once the institution becomes insolvent and the reserved capital must be called upon to satisfy the demands of unsubordinated creditors. Pet. App. A16. As the court of appeals explained, "Any other result would undermine the regulatory protections and priorities accorded innocent third parties who rely upon stated capital reserves." *Ibid.* See also *id.* at A30. In reaching that conclusion, the lower courts properly followed the Second Circuit's decision in *In re Weis Securities, Inc.*, 605 F.2d 590 (1978), cert. denied, 439 U.S. 1128 (1979).

In *Weis*, a securities broker borrowed money to meet the securities industry's regulatory capital requirements. The lenders subordinated their loans to the claims of other creditors in exchange for a higher rate of return. When the broker became insolvent, the lenders sought to rescind the loan agreements based—as here—on claims of fraudulent inducement. The Second Circuit held that the lenders were not entitled to post-insolvency rescission, because the loans were applied to meet regulatory capital requirements and the lenders were estopped, by their acceptance of their subordinated status, to make post-insolvency challenges to that status. 605 F.2d at 596-597. See Pet. App. A11-A14.

The same principle applies in this case. As the court of appeals explained, the regulatory capital requirements of the thrift industry, like those in the securities industry, are designed to protect the interests of the unsubordinated creditors. Pet. App. A13-A14. That protection would be similarly undermined if an investor who purchases a thrift institution's subor-

dinated debentures may rescind his agreement and compromise the associated capital reserves once insolvency occurs. Cf. *Scott* v. *Deweese*, 181 U.S. 202 (1901) (holding that an equity shareholder of a national bank who alleged fraud in the inducement may not obtain a post-insolvency rescission of his subscription).

2. Petitioner mistakenly contends (Pet 12-14) that the court of appeals' decision is inconsistent with this Court's decision in *Oppenheimer* v. *Harriman Nat'l Bank & Trust Co.*, 301 U.S. 206 (1937). In *Oppenheimer*, this Court permitted a shareholder of a national bank to maintain his action for rescission, but *only* after he had paid his statutory liability to other creditors pursuant to 12 U.S.C. 63 (1958) (repealed 1959). *Oppenheimer*, 301 U.S. at 211. The Court explained that the "[p]laintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status." *Id.* at 214 & n. 14 (citing *Scott* v. *Deweese*, *supra*). The Court concluded, however, that "having fully paid his liability to the creditors, there is no reason why his claim should be subordinated to claims of stockholders on account of their deposit balances when the bank failed." 301 U.S. at 215. Thus, the court of appeals' decision follows *Oppenheimer*'s underlying rationale that where an investor in an insolvent institution owes a legal obligation to the institution's general creditors, the investor must satisfy that obligation before it can rescind its investment. See Pet. App. A14 n.17.

Similarly, petitioner is mistaken in contending (Pet. 15-17) that the court of appeals' decision conflicts with the Ninth Circuit's decision in *FDIC* v. *United States Nat'l Bank*, 685 F.2d 270 (1982). In that case, the court permitted a defrauded subordinated debenture

holder to rescind its purchase, because there was no evidence that the debentures were used as regulatory capital. 685 F.2d at 274. Indeed, the statute and regulations that applied in that case did not permit subordinated loans to be used as regulatory capital. *Id.* at 274-275. Hence, as the court of appeals explained, Pet. App. A18 n.20, the Ninth Circuit's decision does not conflict with the court's decision in this case.

3. Petitioner also asserts (Pet. 17-18) that the court of appeals' decision bars investors from pursuing statutory remedies for fraud under the federal securities laws and Minnesota law. The court expressly stated, however, that "we do not hold that a subordinated investor who has agreed to terms and conditions that make his investment eligible for inclusion in regulatory capital never has recourse for fraud. We hold only that such investors may not rescind after the issuing institution has been declared insolvent." Pet. App. A18. Thus, the court of appeals' decision involves only post-insolvency remedies and does not have the broad consequences that petitioner suggests.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

ALFRED J.T. BYRNE
General Counsel

GERALD L. JACOBS
Special Counsel

ANN S. DUROSS
Acting Assistant General Counsel

RICHARD J. OSTERMAN, JR.
Senior Counsel

GREGORY E. GORE
Counsel
Resolution Trust Corporation

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